MAMUSA LOCAL MUNICIPALITY

FINANCE LEASE POLICY

1. DECLARATION OF INTENT
At its broadest level, the Municipal Finance Management Act endeavors "to secure sound and sustainable management of the fiscal and financial affairs of municipalities and municipal entities by establishing norms and standards and other requirements."
In particular, Chapter 12 of the MFMA places the onus on the Municipality to take responsibility for the preparation and adoption of an annual report in accordance with this chapter. More specifically this Chapter provides guidance on the preparation of financial statements, disclosures on intergovernmental and other allocations and other compulsory disclosures.

2. OBJECTIVE

The objective of this policy document is to clearly define the responsibilities of the Mamusa Local Municipality in terms of the Municipal Finance Management Act with respect to the disclosure of Finance leases in the Annual Financial Statements. This policy document addresses the following areas:

- The definition of a Finance lease
- The Accounting policy with respect to Finance leases
- Guidance on the accounting treatment of Finance leases
- Guidance on the disclosure requirements of Finance lease

3. TERMINOLOGY AND DEFINITIONS

In this Policy, unless the context indicates otherwise, a word or expression to which a meaning has been assigned has the same meaning, and –

"Annual Report" in relation to a municipality or municipal entity, means an annual report contemplated in section 121 of the MFMA;

"*Lease"* A **lease** is a contract that gives the lessee (the renter) the right to use an asset for an agreed period of time in return for a payment or series of payments.

"Finance Lease" A **finance lease** is a lease that transfers substantially all risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

"Operating lease" Lease that does not transfer substantially all the risks and rewards of ownership

"Financial Statements" in relation to municipality or municipal entity, means statements consisting of at least—

- A statement of financial position;
- A statement of financial performance;
- A cash-flow statement;
- Any other statements that may be prescribed; and
- Any notes to these statements;

“Financial Year” means a year ending on 30 June.

4. SCOPE OF APPLICATION

From a responsibility perspective, this policy is relevant to all employees of the Municipality, whether full-time or part-time. It is, however, specifically applicable to the Council, Accounting Officer, Chief Financial Officer and Senior Manager’s whether full-time or part-time. In particular, the duly appointed Directorate and responsibility managers have significant roles in:

- *To asses active lease contracts which meet the recognition criteria and definition of Finance lease and disclose it as such in the Annual Financial Statements.*

- *Determining the Rand value of the Finance lease to be disclosed on the Annual Financial Statements.*

5. GOVERNING PRESCRIPTS

This Policy has been formulated in terms of the Municipal Finance Management Act, 2003 (Act 56 of 2003), Generally Recognized Accounting Practice Statement on the Presentation of Financial Statements (GRAP1) and the Generally Recognized Accounting Practice Statement on Leases (GRAP 13).

Legal framework

This policy will be implemented within the legal framework of the relevant national legislation outlined hereunder.

- *The Municipal Finance Management Act, 2003 (Act 56 of 2003)* Sections 121 - 125.

6. ACCOUNTING POLICY

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.
When a lease includes both land and buildings elements, the entity assesses the classification of each element separately.

Finance leases are recognized as assets and liabilities in the statement of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments. The corresponding liability to the lessor is included in the statement of financial position as a finance lease obligation.
The discount rate used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease.
Minimum lease payments are apportioned between the finance charge and reduction of the outstanding liability. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of on the remaining balance of the liability.
Any contingent rents are expensed in the period in which they are incurred.

Operating lease payments are recognized as an expense on a straight-line basis over the lease term. The difference between the amounts recognized as an expense and the contractual payments are recognized as an operating lease asset or liability.

7. GUIDING PRINCIPLES

This policy supports the following principles:

- To secure the sound and sustainable management of the financial affairs of municipalities and other institutions in the local sphere of government;

- To establish treasury norms and standards for the local sphere of government;

- Ensuring transparency, accountability and appropriate lines of responsibility in the fiscal and financial affairs of municipalities and municipal entities;

- The management of the municipality’s revenues, expenditures, assets and liabilities and the handling of their financial dealings.

7.1 GUIDING PRINCIPLES: INITIAL RECOGNITION AND SUBSEQUENT MEASUREMENT OF FINANCE LEASE

Initial Recognition

GRAP 13 paragraph 26 to 31 states the following with regards to the initial recognition of Finance Leases:

At the commencement of the lease term, lessees shall recognize assets acquired under finance leases as assets and the associated lease obligations as liabilities in their statement of financial position. The assets and liabilities shall be recognized at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognized as an asset.

Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with legal form. Although the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits or service potential of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating, at the inception of the lease, the fair value of the asset and the related finance charge.

If such lease transactions are not reflected in the lessee's financial statements, the assets and liabilities of an entity are understated, thereby distorting financial ratios. Therefore, it is appropriate for a finance lease to be recognized in the lessee's financial statements both as an asset and as an obligation to pay future lease payments. At the commencement of the lease term, the asset and the liability for the future lease payments are recognized in the financial statements at the same amounts except for any initial direct costs of the lessee that are added to the amount recognized as an asset.

It is not appropriate for the liabilities for leased assets to be presented in the financial statements as a deduction from the leased assets.

If for the presentation of liabilities on the face of the statement of financial position a distinction is made between current and non-current liabilities, the same distinction is made for lease liabilities.

Initial direct costs are often incurred in connection with specific leasing activities, such as negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are added to the amount recognized as an asset.

Subsequent Measurement

Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the

liability. Contingent rents shall be charged as expenses in the periods in which they are incurred.

In practice, in allocating the finance charge to periods during the lease term, a lessee may use some form of approximation to simplify the calculation.

A finance lease gives rise to a depreciation expense for depreciable assets as well as finance expense for each accounting period. The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognized shall be calculated in accordance with the Standard of GRAP on Property, Plant and Equipment and the International Accounting Standard on Intangible Assets. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of the lease term and its useful life.

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the shorter of the lease term and its useful life.

The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognize the lease payments payable as an expense. Accordingly, the asset and the related liability are unlikely to be equal in amount after the commencement of the lease term.

To determine whether a leased asset has become impaired an entity applies relevant impairment tests in the Standards of GRAP on *Impairment of Cash generating Assets* and *Impairment of Non-cash-generating Assets*.

7.2 GUIDING PRINCILES DISCLOSURE

With regards to the Finance Lease Asset, GRAP 13 Paragraph 38 states the following:

> (a)For each class of asset, the net carrying amount at the reporting date.

Regarding the Finance Lease Liability GRAP 13 Paragraph 38 states the following:

> (b) A reconciliation between the total of future minimum lease payments at the reporting date, and their present value. In addition, an entity shall disclose the total of future minimum lease payments at the reporting date, and their present value, for each of the following periods:
>
> > (i) Not later than one year;
> > (ii) Later than one year and not later than five years; and
> > (iii) later than five years;
>
> (c) Contingent rents recognized as an expense in the period;
> (d) The total of future minimum sublease payments expected to be received under non-cancellable subleases at the reporting date;
> (e) A general description of the lessee's material leasing arrangements including, but not limited to, the following:
>
> > (i) The basis on which contingent rent payable is determined;

(ii) The existence and terms of renewal or purchase options and escalation clauses; and

(iii) Restrictions imposed by lease arrangements, such as those concerning return of surplus, return of capital contributions, dividends or similar distributions, additional debt and further leasing; and

(f) The depreciation and the finance charge relating to the leased asset shall be included as part of the total depreciation and finance charges respectively.

In addition, the requirements for disclosure in accordance with the Standards of GRAP on *Investment Property, Property, Plant and Equipment, Intangible Assets, Agriculture*, *Impairment of Cash-generating Assets* and *Impairment of Non-cash-generating Assets* are applied to the amounts of leased assets held under finance leases that are accounted for by the lessee as acquisitions of assets.

7.3 GUIDING PRINCIPLES: REQUIRED DISCLOSURE NOTE FOR FINANCE LEASE

Finance lease obligation

Minimum lease payment due	
-Within one year	RXXX XXX
-In second to fifth year	RXXX XXX
-Later than five years	RXXX XXX
Total	**RXXX XXX**
-Less Future finance charges	(RXXX)
-Present value of minimum lease payments	**RXXX XXX**
Present value of minimum lease payments due	
-Within one year	RXXX XXX
-In second to fifth year	RXXX XXX
-Later than five years	RXXX XXX
	RXXX XXX
Non-current liabilities	**RXXX XXX**
Current liabilities	**RXXX XXX**
	RXXX XXX